

## Internal Revenue Service, Treasury

## § 1.312-6

in computing inventories for the purpose of the computation of taxable income. Section 312(b) does not apply to distributions described in section 312(e).

### § 1.312-3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

[T.D. 7209, 37 FR 20804, Oct. 5, 1972, as amended by T.D. 8586, 60 FR 2500, Jan. 10, 1995]

### § 1.312-4 Examples of adjustments provided in section 312(c).

The adjustments provided in section 312(c) may be illustrated by the following examples:

*Example (1).* On December 2, 1954, Corporation X distributed to its sole shareholder, A, an individual, as a dividend in kind a vacant lot which was not an inventory asset. On that date, the lot had a fair market value of \$5,000 and was subject to a mortgage of \$2,000. The adjusted basis of the lot was \$3,100. The amount of the earnings and profits was \$10,000. The amount of the dividend received by A is \$3,000 (\$5,000, the fair market value, less \$2,000, the amount of the mortgage) and the reduction in the earnings and profits of Corporation X is \$1,100 (\$3,100, the basis, less \$2,000, the amount of mortgage).

*Example (2).* The facts are the same as in *Example (1)* above with the exception that the amount of the mortgage to which the property was subject was \$4,000. The amount of the dividend received by A is \$1,000, and there is no reduction in the earnings and profits of the corporation as a result of the distribution (disregarding such reduction as may result from an increase in tax to Corporation X because, of gain resulting from the distribution). There is a gain of \$900 recognized to Corporation X, the difference between the basis of the property (\$3,100) and the amount of the mortgage (\$4,000), under section 311(c) and an increase in earnings and profits of \$900.

*Example (3).* Corporation A, having accumulated earnings and profits of \$100,000, distributed in kind to its shareholders, not in

liquidation, inventory assets which had a basis to it on the "Lifo" method (section 472) of \$46,000 and on the basis of cost or market (section 471) of \$50,000. The inventory had a fair market value of \$55,000 and was subject to a liability of \$35,000. This distribution results in a net decrease in earnings and profits of Corporation A of \$11,000, (without regard to any tax on Corporation A) computed as follows:

"Fifo" basis of inventory .....	\$50,000	
Less: "Lifo" basis of inventory .....	46,000	
Gain recognized—addition to earnings and profits (section 311(b)) .....		\$4,000
Adjustment to earnings and profits required by section 312(b)(1)(A):		
Fair market value of inventory .....	\$55,000	
Less: "Lifo" basis plus adjustment under section 311(b) .....	50,000	5,000
Total increase in earnings and profits .....		9,000
Decrease in earnings and profits—under section 312(b)(1)(B)(i) .....	\$55,000	
Less: Liability assumed .....	35,000	
Net amount of distribution (decrease in earnings) ....		20,000
Net decrease in earnings and profits .....		11,000

### § 1.312-5 Special rule for partial liquidations and certain redemptions.

The part of the distribution properly chargeable to capital account within the provisions of section 312(e) shall not be considered a distribution of earnings and profits within the meaning of section 301 for the purpose of determining taxability of subsequent distributions by the corporation.

### § 1.312-6 Earnings and profits.

(a) In determining the amount of earnings and profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated before March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income (or net income, as the case may be). For instance, a corporation keeping its books and filing its income tax returns under subchapter E, chapter 1 of the Code, on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect